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June 19, 2006

AGENDA ITEM 10-B

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Assembly Bill 2941 (Koretz) – As Amended May 26, 2006

Sudan Divestment

Sponsor: Sudan Divestment Task Force; Sacramento Committee on Conscience

II. PROGRAM: Legislation

III. RECOMMENDATION: Oppose

This bill would limit the authority of the CalPERS Board in making investment decisions.

IV. ANALYSIS:

This bill would prohibit the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) from investing in a company with business operations in the Sudan, that meet specified criteria, and would require the boards of these retirement systems to sell or transfer any investments in these companies within specified timeframes. The boards of these retirement systems would be required to submit a specified annual report to the Legislature on or before January 1, 2008.

Background

CalPERS staff presented AB 2941 as an information item at the May 15, 2006 Investment Committee meeting (Attachment 1). Staff was in discussions with the author regarding amendments to the bill and, as such, recommended not taking a position at that time. AB 2941 has since been amended and this agenda item discusses the bill and its recent amendments.

Constitutional Authority and Fiduciary Responsibility

Article XVI, section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement boards of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the fiduciary of the public pension or retirement system to discharge his or her duties solely in the interest of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the systems so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so. In accordance with California Constitution Article XVI, Section 17, the Board's constitutional duties take precedence over any other considerations.

The Constitution, however, also provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

<u>CalPERS' Constructive Engagement Approach</u>

CalPERS believes that constructive engagement is the most powerful tool available to investors to effect change, and it is through active ownership that CalPERS constructively engages those portfolio companies whose corporate governance, social, and environmental practices could lead to value destruction. In response to the atrocities taking place in Sudan, CalPERS has developed an extensive framework to support a constructive engagement plan with CalPERS' portfolio companies that have business operations in Sudan. Since November 2004, CalPERS' efforts to identify and engage companies operating in Sudan have been:

- Consulted four Federal Authorities (U.S. Department of Commerce, U.S. Department of State, U.S. Department of the Treasury, and the U.S. Securities and Exchange Commission) with a coalition of 49 other pension funds;
- Contacted 1,869 portfolio companies and 46 external managers;
- Formed a second coalition (Sudan Coalition) with four other public pension funds to constructively engage companies;
- Continued monitoring of the U.S. Department of the Treasury's Office of Foreign Asset Control (OFAC).

Through the collective efforts discussed above and a review of multiple sources, CalPERS initially identified five companies in the total CalPERS' portfolio that were doing business in Sudan. Through continued efforts of CalPERS staff, and in conjunction with third party sources, CalPERS has identified several additional portfolio companies as doing business in the Sudan.

In addition to identifying companies through third-party sources such as the Office of Foreign Asset Control (OFAC) and the Sudan Coalition, staff continues its efforts to identify credible third-party consultants to assist in the identification of companies doing business in Sudan. Staff has engaged F&C Asset Management, a leading investment company located in the United Kingdom, and continues to dialogue with Oxford Analytica to explore potential opportunities to assist CalPERS' efforts to identify and engage companies doing business in Sudan.

CalPERS has a comprehensive ongoing constructive engagement plan with respect to portfolio companies identified as doing business in the Sudan. In addition, the Board recently adopted a nine point Position Statement pertaining to companies doing business in Sudan (Attachment 2) as a reflection of CalPERS' principle to effect positive change and ensure sustainable long-term returns. To accomplish this end, CalPERS uses its leverage as a shareowner to constructively engage portfolio companies whose corporate governance, social and environmental practices could lead to value destruction. Company engagement through active ownership provides CalPERS the opportunity to more effectively alter the actions of portfolio companies that impede sustainable long-term economic returns.

The Sudan Position Statement is conditioned, in part, upon enactment of legislation that would indemnify the retirement funds for losses, in addition to the individual board members, officers, agents, and employees of the system for all costs, liability and losses.

CalPERS' constructive engagement plan is also consistent with Assembly Concurrent Resolution 11 (ACR 11, Dymally), supported by the CalPERS Board and adopted by the Legislature in 2005, which encouraged CalPERS and CalSTRS, within their fiduciary responsibilities, to encourage companies in which employee retirement funds are invested that are doing business in Sudan to act responsibly and not take actions that promote or otherwise enable human rights violations in Sudan.

For more information on these continued efforts, please refer to Agenda Item 6c, Update on Investments in Companies Doing Business in the Sudan.

Proposed Changes

This bill declares the Legislature's intent to limit investing public retirement funds in business firms and financial institutions with ties to the reprehensive regime of Sudan because it is inconsistent with the moral and political values of the people of California. The Legislature, however, expressly acknowledges in the bill's intent language that divestment is a course of last resort that should be used sparingly and under extraordinary circumstances. As such, the Legislature declares that this bill is not intended to set precedent with regard to divestment policies and practices by public pension funds in California.

To carry out this intent, this bill would prohibit CalPERS and CalSTRS from investing in a company with business operations in Sudan, as specified, and require the boards of these retirement systems to sell or transfer any investments with these companies and report to the Legislature regarding these investments. Specifically, this bill would:

1. Prohibit the boards of CalPERS and CalSTRS from investing in a company with business operations in the Sudan that meet **all** of the following criteria:

   a. The company is engaged in business operations that provide revenue to the government of Sudan or is engaged in oil-related activities; and
   b. Either (1) the company has failed to take substantial action, as defined, related to the government of Sudan because of the Darfur genocide; or (2) the company has demonstrated complicity in the Darfur genocide.

   Substantial action is defined as a boycott of the government of Sudan, curtailing business in Sudan while the bill remains in effect, selling company assets, equipment or real or personal property located in Sudan, or undertaking significant humanitarian efforts in the country's Eastern, Southern or Western regions.

2. Notwithstanding the above criteria, the boards would be absolutely prohibited from investing in a company that supplies military equipment within the borders of Sudan.

3. Require CalPERS and CalSTRS to contract with a research firm, or firms, to determine those companies that have business operations in Sudan. The research firm, or firms, must report its findings to each board on or before March 30, 2007, and update those reports as circumstances in Sudan change.

4. In addition to the report from the research firm, or firms, the boards would be required to supplement the research firm's report by taking the following actions by March 30, 2007:

   a. Review publicly available information regarding companies with business operations in Sudan;
   b. Contact other institutional investors that invest in companies with business operations in Sudan; and
   c. Send written notice to a company with business operations in Sudan that the company may be subject to this section.

5. Require the boards to determine, by the board meeting following the March 30, 2007 deadline and based on the information and reports compiled and received, whether a company meets the divestment criteria described.
6. Require the boards in instances where the investment in a company doing business in Sudan is limited to investment via an externally and actively managed commingled fund to contact the fund or account manager in writing to request removal of the company with business operations in Sudan from the fund. If an alternative fund or account manager produces an actively managed, commingled fund that excludes companies that meet all of the divestment

criteria and that fund is deemed financially equivalent, then the boards may transfer funds and satisfy divestment requirements.

7. Require the boards to engage constructively with each company identified through composite information that meets divestment criteria. The company would have the opportunity to respond to the information. In addition, the boards would be required to urge the company to engage in substantial action as defined, no later than 90 days from the date the board notified the company.

   If, in the opinion of the board, the company has taken substantial action or has made sufficient progress towards substantial action before the expiration of the 90 day period of engagement by the board, then the company would not be subject to divestment, provided the company maintains the activity qualifying as substantial action, or continues implementation of the activity at a reasonable pace.

8. If the boards find that a company has business operations in Sudan and meets all of the divestment criteria, the boards would be required to take the following action:

   a. The boards would not make additional or new investments or renew existing investments in those companies; and
   b. Upon exhaustion and failure of the constructive engagement process, the boards would be required to direct liquidation of its investments in those companies no later than 18 months after the failure of the constructive engagement. The boards would be required to liquidate in a timeframe and manner that acknowledges the need for rapid and substantive action, but is also consistent with the boards' fiduciary responsibility for investment of retirement system assets pursuant to Section 17 of Article XVI of the Constitution.

9. On or before January 1, 2008, and every year thereafter, each board would be required to file a report with the Legislature. The report must describe the following:

   a. A list of investments in companies with business operations in Sudan;
   b. A detailed summary of the business operations a company described in the first part of this report has in Sudan and whether that company satisfies all of the divestment criteria;
   c. Whether the board has reduced its investments in a company that satisfies the divestment criteria;
   d. When the board anticipates it will reduce all investments in companies satisfying divestment criteria, or the reasons why a sale or transfer of investments is inconsistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution;

   e. Any information described in the board's evaluation of the research firm's report and its own research; and
   f. A detailed summary of investments that were transferred to funds or accounts devoid of companies with business operations in Sudan as described.

10. The boards would not, however, be required to take any action pursuant to this section unless the boards determine, in their discretion, that such action is consistent with their plenary authority and fiduciary responsibility for investment of retirement system assets pursuant to Section 17 of Article XVI of the Constitution.

11. Divestment would not apply to any of the following:

    a. Investments in a company that is clearly engaged in the provision of goods and services intended to relieve human suffering in Sudan or to promote health, education, journalistic or religious activities in Sudan; or
    b. Investments in United States (U.S.) companies authorized by the federal government to do business in Sudan.

12. Hold harmless and indemnify from the General Fund present, future and former board members, jointly and individually, state officers and employees, the research firms retained by the board and all investment managers under contract with CalPERS and CalSTRS from all claims, demands, suits, actions, damages, judgments, costs, charges and expenses, including court costs and attorney's fees, and against all liability, losses or damages sustained by reason of any decision to restrict, reduce or eliminate any investments pursuant to this bill.

13. Provide that these requirements only remain in effect until Sudan halts genocide for 12 months as determined by the State Department and U.S. Congress or if the U.S. Government revokes its current sanctions on Sudan.

Legislative History

2005 Chapter 57 (AJR 6, Koretz) – Declared the Sudanese government should condemn all actions and crimes committed by the Janjaweed, ensure all militias are disarmed and disbanded, humanitarian workers must be given full and unimpeded access to Darfur, Sudan should put in measures to ensure these crimes never happen again, and that these resolutions be transmitted to the highest federal authorities and the United Nations Secretary General. *CalPERS Position: None*

Chapter 98 (ACR 11, Dymally) – Encouraged CalPERS and CalSTRS, within their fiduciary responsibilities, to urge companies that invest in Sudan to act responsibly and not take actions that promote or otherwise enable human rights violations in Sudan. *CalPERS Position: Support*

2001 SJR 9 (Costa) – Would have urged the Federal government to assume its proper leadership role in assisting investors in avoiding investing in entities that are deemed threats to the national security of the United States. Failed passage. *CalPERS Position: Sponsor*

2000 AB 107 (Knox) – Would have prohibited CalPERS and CalSTRS from making any new or additional investments in tobacco companies beginning January 1, 2001 and would have required divestment of existing investments by July 1, 2002. Failed Passage. *CalPERS Position: Oppose*

SB 1928 (Haynes) – Would have required CalPERS and CalSTRS to report on the extent to which they are invested in foreign companies that pose threats to national security, and would have encouraged the boards of these pension funds not to invest in those companies. Held in Assembly. *CalPERS Position: Oppose*

1998 AB 1679 (Perata) – Would have prohibited state trust fund and state money investments in tobacco companies. Failed Passage. *CalPERS Position: Oppose*

AB 1744 (Knox) – Would have prohibited CalPERS and CalSTRS from making new or additional investments in any tobacco company on or after January 1, 1999. This bill would have also required a phased divestment of those investments beginning January 1, 2000 and continuing until January 1, 2002. Failed Passage. *CalPERS Position: Oppose*

SB 1433 (Hayden) – Would have required CalPERS and CalSTRS to not make new or additional investments in tobacco companies. Failed Passage. *CalPERS Position: Oppose*

1994 Chapter 30 (SB 1285, Watson) – Repealed provisions prohibiting investments in South Africa. *CalPERS Position: Support*

1986 Chapter 1254 (AB 134, Waters) – Prohibited the use of state trust funds or state moneys to make additional or new investments, or to renew existing investments in firms doing business with or in South Africa as of January 1, 1987. *CalPERS Position: Neutral*

1983 (AB 808, Watson)—Would have prohibited the use of state funds for investment in the stock of financial institutions having outstanding loans to the government of South Africa after January 31, 1985. Would have required complete divestment of state funds in any U.S. company doing business in South Africa by January 1, 1989. Would have provided an exception for any financial institution adopting a policy including a commitment not to renew existing loans or to make new loans to the South African public sector. Vetoed by Governor Deukmejian. *CalPERS' Position: Oppose*

Issues

1. Arguments in Support

   The sponsor, Sudan Divestment Task Force, states, "The Sudanese government supports and finances the Arabic militia known as the Janjaweed who are carrying out what is referred to as ethnic cleansing. Several major companies including ChinaPetrol, ABB, Ltd., Alcatel and Siemens AG all have business ties with the Sudanese government and all government-controlled entities. These companies present a financial risk and a moral threat to their shareholders. Both CalPERS and CalSTRS are in unique positions to put pressure on the Sudanese government to stop supplying arms to the Janjaweed militia. By divesting our western interests, we encourage the government to act responsibly and not take actions that promote or otherwise enable human rights violations."

   Organizations in Support: Sudan Divestment Task Force (sponsor); Sacramento Committee on Conscience (sponsor); Phil Angelides, State Treasurer; California Federation of Teachers; American Federation of State, County and Municipal Employees.

2. Arguments in Opposition

   There is no known registered opposition at this time.

3. This bill, as amended, continues to dictate certain investment decisions by the Board, but now provides that any such actions shall be consistent with the Board's fiduciary responsibilities.

   At the May 16, 2006 meeting of the Investment Committee, staff reported that, as then drafted, AB 2941 mandated investment restrictions and strict deadlines that would impinge upon the board's constitutional plenary authority and fiduciary responsibility to invest the assets of the retirement fund in the exclusive interest of CalPERS' participants and beneficiaries. In addition, as then drafted, the bill would have infringed upon the board's fiduciary duties to maximize investment returns on behalf of its membership and meet its benefit obligations.

   The bill, as amended and in its current form, now acknowledges the fiduciary responsibilities of the boards of retirement funds. AB 2941, as amended, still prohibits the board from investing in a company with business operations in Sudan if the company meets certain listed criteria. The bill would additionally prohibit investments in companies that supply military equipment within the borders of Sudan. If the board plans to invest or has investments in a company that meets the listed criteria or supplies military equipment, then the board is required to request that the company take substantial action within 90 days. If the company fails to take substantial action, then the board is prohibited from making additional or new investments or renewing existing investments in the company and is required to liquidate the investments in the company no later than 18 months. However, the bill now provides that such liquidation is to be taken in a manner that addresses the need for companies to take substantial action *consistent with the board's fiduciary responsibilities described in Section 17 of Article XVI of the Constitution*. In addition, the bill now includes a subdivision that states that "nothing in this section shall require the board to take any action as described in this section unless the board determines, in its discretion, that the action described in this section is consistent with the fiduciary responsibilities of the board as described in Section 17 of Article XVI of the California Constitution.

Accordingly, as amended, AB 2941 now acknowledges the fiduciary responsibility of the CalPERS Board.

4. Indemnification provision does not indemnify the fund

   The bill includes an indemnification provision identical to the one contained in AB 134 that enacted the South Africa divestment requirement in 1986. Specifically, this bill would provide that the State General Fund shall indemnify present, future and former CalPERS' Board members, state officers and employees, research firms retained by the Board, and investment managers from all liability, losses or damages sustained by reason of any decision to restrict, reduce or eliminate any investments pursuant to provisions of this bill.

   Staff has requested that Assembly Member Koretz amend AB 2941 to expand the indemnity provision to cover losses to the retirement fund, itself. However, the author is not willing to amend AB 2941 to include indemnification of the fund.

5. Adverse impact to the CalPERS Supplemental Savings Program

   The bill, as written, would also apply to the CalPERS Supplemental Savings Program (SSP). Through the SSP the CalPERS Board currently holds in trust approximately $1.7 billion in assets from defined contribution pension plans that are not part of the Public Employees' Retirement Funds. Within that trust, CalPERS manages $875 million under an interagency agreement with the Department of Personnel Administration (DPA) to provide an S&P Index Fund for the State Savings Plus Program. Another $6.3 million is managed under a separate administrative services agreement to provide the City of Anaheim with an S&P Index Fund. In both cases, DPA and the City of Anaheim are the trustees of their respective deferred compensation plans. If CalPERS is required to alter its S&P 500 Index Fund as a result of AB 2941, the terms of the contracts with DPA and the City of Anaheim could be violated.

   Staff is working with the author to amend the bill to limit the divestment criteria to the Public Employees' Retirement Funds, which would not include the plans in the SSP.

6. Holding the research firm to the same fiduciary standards as CalPERS

   This bill would require the Board to contract with a research firm to determine those companies that have business operations in Sudan. CalPERS must then move forward with procedures to engage the company and/or divest within their fiduciary duty. In order for CalPERS to base its investment decisions which will be held to the Board's fiduciary responsibility, on a research firm's recommendation, the research firm should be held to the same fiduciary standards. This alignment is necessary to ensure the same level of criteria is used in the identification process as in the divestment decision process.

7. Pending lawsuit on Sudan Divestment against the State of Illinois

   The National Foreign Trade Council (NFTC) is moving forward with litigation against the State of Illinois regarding its Sudan divestment law. Following is a summary recently prepared by the NFTC outlining the case.

   The NFTC finds this case equally as strong as the one it brought against a Massachusetts law regarding Burma (Crosby v. NFTC). In Crosby, the Supreme Court ruled unanimously in favor of the NFTC and held that states were preempted under the Supremacy Clause of the Constitution from acting where Congress and the executive have already addressed the question of sanctions. The Supreme Court held in Crosby that federal law preempts state law where "the challenged state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives" of federal law. Crosby held that Massachusetts' Burma law, which prohibited state agencies from purchasing goods and services from companies doing business with Burma, undermined the federal Burma law's limitation of sanctions to a limited scope of actions and actors, specific delegation to the President of flexible discretion and the direction to the President to develop a comprehensive, multilateral strategy. Illinois' Sudan Law presents the same basic conflicts with federal statutes, presidential executive orders and federal regulations. To whit, the U.S. already imposes sanctions on Sudan: President Bill Clinton signed an order in 1997 that restricted the flow of most goods and services to and from the country, and President Bush has continued them, most recently extending the sanctions for another year on November 1. Congressional Acts specifically cite intent to have a multilateral broad regime with targeted policies, which cannot be accomplished through a piecemeal approach in every state. The NFTC noted that Congress specifically barred market-based sanctions. While they were added to bills in 2002 and 2004, they were opposed and ultimately omitted. The Illinois law on Sudan divestment should be invalid for the same reasons that the Supreme Court in Crosby struck down the Massachusetts Burma law.

8. Timelines in the bill may not be sufficient

   Although the recent amendments have extended the date the first annual report is due to the Legislature to January 1, 2008 and timeframes for liquidating investments in companies that fail to take substantial action, the author has been unwilling to extend the March 30, 2007 deadline requiring the Board to contract with a research firm to determine which companies have business operations in Sudan and have the research firm report such findings to the Board.

In addition to the research firm's reports, by March 30, 2007 the Board must also review publicly available information regarding companies with business operations in Sudan; contact other institutional investors that invest in companies with business operations in Sudan; and send written notices to companies with business operations in Sudan informing them that the company may be subject to provisions of this bill.

The bill also requires that at the first Board meeting following the submission of the aforementioned information, the Board must determine if a company meets the divestment criteria. The Board must then notify each company identified in the report that the Board will reduce its investments in that company within 90 days from the date the Board notifies the company, unless the company takes substantial action as defined.

These timelines may not be achievable in all circumstances. There are many factors that will determine how well CalPERS can comply with these timelines. Some factors are outside CalPERS' control, such as the ability of an independent research firm to clearly identify and document companies which meet divestment criteria, additional research by an independent research firm, or additional input from federal agencies to identify the extent of a company's role with the government of Sudan.

9. <u>UC Regents Indemnification Bill – AB 2179 (Leslie)</u>

The University of California Regents voted unanimously during their March 16, 2006 meeting to divest from nine companies with business operations in the Sudan, and constructively engage with other companies. This divestment action prohibits future investment in the nine companies until such a time as there is compelling information that a company has materially improved its operation and is no longer thought to be contributing to the suffering in Darfur.

Implementation of the proposed divestment policy is conditioned upon enactment of AB 2179, indemnification legislation. This bill was introduced February 22, 2006 and amended March 30, 2006. This bill would indemnify, from the General Fund, any current or former member of the UC Board of Regents, officers, employees or investment managers. Specifically, this bill would indemnify these individuals from all claims, demands, suits, actions, damages, judgments, costs, challenges, and expenses against all liability, losses and damages of any nature whatsoever sustained by these individuals as a result of any decision not to invest in any firm involved in significant business activities that provide revenue to the Sudanese government.

10. CalPERS' Legislative Policy Standards

The Board's Legislative Policy Standards suggest an oppose position on proposals which impose any investment mandate or restriction on the Board's investment authority. AB 2941 would limit the Board's authority to decide whether or not CalPERS should retain or divest its holdings in companies doing business in Sudan.

V. STRATEGIC PLAN:

This item is not a specific product of the Annual or Strategic Plans, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

AB 2941 would impinge on the Board's policy-setting and decision-making authority with regard to investments in certain companies doing business in Sudan. However, the Board would retain fiduciary responsibility and liability for the impact of this legislative mandate. Current law does not preclude the Board from reviewing any and all factors that it deems appropriate in making investment decisions, including a decision to divest. As fiduciaries, the Board must maintain complete authority in establishing and implementing investment policy.

The cost of AB 2941 is difficult to determine because the actual cost will depend on the following: (1) the companies identified by the research firm; (2) the criteria for divestment provided in the final version of the bill, (3) CalPERS' holdings in those companies; and (4) the timing for such divestment.

Program Costs

Cost of transitioning the securities for divestment into other securities

One time costs per security:
This cost will depend on the CalPERS' holdings in the companies identified by the research firm and the criteria for divestment in the enacted version of AB 2941, however, it is estimated that the average transaction cost of divestment will be approximately $1.9 million per security. Transaction costs will vary based upon the shares held in any individual company. This cost analysis was reviewed by Wilshire Associates, the Board's independent pension consultant, and deemed to be reasonable. This estimate includes commissions to sell the securities, local country taxes, the commissions to redeploy the capital as well as the commissions and taxes to reinvest the capital once the divestment period is over.

Other unquantifiable costs

There are a number of other costs not included in the analysis above because they are not currently measurable; among them are "market impact costs" related to security sales and "opportunity cost" related to lost appreciation on the securities in the event they appreciate in price. These costs cannot be predicted, but may be substantial.

Any such decrease in investments will ultimately be paid for by the employers – the State, Schools, and Contracting Public Agencies

In the event that there is a decrease in investment returns as a result of divestment, the employers would be responsible for making up the difference because member contributions are fixed by law.

Administrative Costs

CalPERS estimates administrative costs to be between $125,000 to $150,000 as outlined below.

Research Firm
The cost of a third party research service to develop a list of companies from which to divest will be approximately $50,000 per year. It is anticipated that CalPERS will need this list for at least two years for a total of $100,000.

Fiduciary Counsel
The estimated cost of an outside fiduciary counsel opinion will be approximately $25,000 to $50,000.

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